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In the Supreme Court of the United States

OCTOBER TERM, 1978

SOUTHLAND ROYALTY COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Washington, D.C. 20530

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The question presented in this federal income tax case is whether the Court of Claims correctly held that costs incurred by petitioner in a law suit that determined its right to a reversion under an oil lease agreement were not currently deductible but were capital expenditures because the suit involved the defense or perfection of petitioner's title to the land.

The pertinent facts are as follows: Petitioner, and its co-lessors, are successors in interest to W. N. Waddell and others, who in 1925 granted an oil and gas lease on 45,771 acres of land they owned in Crane County, Texas, to Gulf Production Company. The lease was for a term of 12 years and for as long thereafter as oil or gas was produced from the land. The lease agreement further provided that "this lease shall not remain in force longer than fifty (50) years" from the date of execution (Pet. App. A-9).

Gulf successfully drilled many oil and gas wells on the property and, by 1967, was operating approximately 900 producing oil and gas wells. Production from these wells, however, was subject to the jurisdiction of the Texas Railroad Commission. That Commission ordered a halt to production for 197 days between January, 1938, and March, 1940, and thereafter issued monthly proration orders which restricted the amount of gas and oil that could be produced from the wells (Pet. App. A-9 to A-10).

In 1967, Gulf commenced an action in the Texas courts seeking a declaratory judgment that the production delays resulting from these orders should not be counted against it in determining the date upon which the 50-year term of the lease would expire. Gulf maintained that the lease should not expire until 1987, some 12 years later than the initial 50-year term. Petitioner and its co-lessors opposed the suit and were eventually successful in obtaining a judgment that the lease would expire in 1975, 50 years from the commencement of the lease. See *Gulf Oil Corp.* v. *Southland Royalty Co.*, 496 S.W.2d 547 (Tex. 1973) (Pet. App. A-10 to A-11).

During 1967 and 1968, petitioner accrued approximately $135,000 in costs in connection with its defense of Gulf's suit, and deducted those amounts on its income tax returns for those years. On audit, the Commissioner of Internal Revenue disallowed the deductions on the ground that they were capital expenditures. In this refund suit brought by petitioner, the Court of Claims upheld the Commissioner. As it saw the matter, petitioner incurred the legal expenses at issue in order to have and control the lease for a period of 12 years. The Court reasoned that since the origin and the principal purpose of the legal expenses centered on petitioner's claims to unfettered title to the land, they should be capitalized and not currently deducted (Pet. App. A-11 to A-18).

The decision below correctly held that petitioner's costs in defense of Gulf's suit over the oil lease were capital expenditures that were not currently deductible but could only be recovered if and when petitioner sold the land subject to the lease. As this Court recognized in *Woodward* v. *Commissioner*, 397 U.S. 572, 576 (1970), it is well established that the costs incurred in prosecuting a law suit "are capital in nature * * * where the taxpayer's 'primary purpose' in incurring them is to defend or perfect title" to property. See, *e.g.*, *Morgan's Estate* v. *Commissioner*, 332 F. 2d 144 (5th Cir. 1964); *Industrial Aggregate Co.* v. *United States*, 284 F. 2d 639 (8th Cir. 1960); *Rassenfoss* v. *Commissioner*, 158 F. 2d 764 (7th Cir. 1946).

There is no basis for challenging the Court of Claims' conclusion that the primary purpose of petitioner's defense against Gulf's suit was the defense or perfection of its title to the leasehold property. Indeed, the only issue presented by the suit was whether petitioner was entitled to unfettered title to the oil and gas property at the end of 50 years after the lease was executed, rather than 12 years later, as Gulf contended. The court below therefore correctly held that the litigation costs should be capitalized as costs incurred to defend or perfect title. See *Industrial Aggregate Co.* v. *United States, supra; Georator Corp.* v. *United States*, 485 F. 2d 283 (4th Cir. 1973), cert. denied, 417 U.S. 945 (1974).[1]

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[1] In *California* v. *Southland Royalty Co.*, 436 U.S. 519 (1978), this Court held that, under the terms of the Natural Gas Act, petitioner could not withdraw gas obtained from the present leasehold from interstate commerce without first obtaining permission from the Federal Energy Regulatory Commission. The fact that Gulf's election to distribute the gas produced from the leasehold in interstate commerce operated, to some extent, to encumber the gas petitioner produced after termination of Gulf's lease, in no way diminishes petitioner's acquisition of the right to exploit the gas deposits on the leasehold, which was gained in part as a result of the litigation with Gulf. That fact, rather than the incidental effects of the Natural Gas Act, is the critical consideration for purposes of this federal tax case.

Contrary to petitioner's argument (Pet. 13-18), the decision below is entirely in accord with *United States* v. *Gilmore*, 372 U.S. 39 (1963). *Commissioner* v. *Bosch*, 387 U.S. 456 (1967), and *Industrial Aggregate Co.* v. *United States, supra*. In *Gilmore*, this Court held that the "origin" of the claims at issue in a law suit should determine whether the costs should be classified as nondeductible personal expenses (see Section 262 26 U.S.C.) or as deductible ordinary and necessary costs incurred for the "conservation" of "property held for the production of income" (see Section 212). Here, while the legal expenses originated in claims relating to property held for the production of income, they also related directly to "title" to that property. As we have shown *supra*, such costs are nondeductible capital expenditures despite their relation to income-producing property. See Treasury Regulations on Income Tax (1954 Code), Section 1.212-1(k).

Moreover *Commissioner* v. *Bosch, supra*, is not to the contrary. The decision below gives full recognition to the fact that the claims pressed before the state courts and the decisions that emanated from the litigation focused entirely upon petitioner's and Gulf's respective claims to the leasehold property.

Finally, the decision below is consistent with *Industrial Aggregate Co.* v. *United States, supra*. There, the court recognized the principle upon which the Court of Claims grounded its decision in this case when it stated that "if the primary or sole purpose of [a] * * * suit is to perfect or defend title, the expenditures [incurred in prosecuting or defending the suit] are not deductible" (284 F. 2d at 645). It went on, however, to conclude that the primary purpose of the litigation that gave rise to the expenses there in dispute was not the perfection or defense of title, but rather "the resolution of the issue of the taxpayer-lessee's alleged violations of the operating covenants of the four leases" (*id.* at 647). Under those circumstances, the court held that the taxpayer was entitled to deduct the

litigating expenses involved, even though the taxpayer's right to extend certain leases hinged upon the resolution of that primary issue. Here, on the other hand, the determination of petitioner's right to obtain unfettered possession of the leasehold property was by no means subsidiary to any other claim. It was the only question presented in the state court litigation.

It is therefore respectfully submitted that the petition for certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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